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5.0 BUILT IN GAINS TAX

5.1 PURPOSE OF THE BUILT-IN GAINS TAX

The General Utilities rule tends to undermine the corporate income tax. Under normally applicable tax principles, nonrecognition of gain is available only if the transferee takes a carryover basis in the transferred property, thus assuring that a tax will eventually be collected on the appreciation. Where the General Utilities rule applies, assets generally are permitted to leave corporate solution and to take a stepped-up basis in the hands of the transferee without the imposition of a corporate-level tax. Thus the effect of the rule is to grant a permanent exemption from the corporate income tax.

Congress repealed the General Utilities Doctrine. As a result, a corporation will generally recognize a gain or loss on the distribution of assets. Thus, the principle of double taxation was extended to all distributions and sales of appreciated property by C corporations. However, Congress was concerned that closely held C corporations would circumvent the corporate level tax on liquidating distributions by converting the corporations to S status then liquidate after three years to avoid pre-1986 capital gains tax. To prevent circumvention of the corporate level tax, section 632 of the 1986 Tax Reform Act revised IRC §1374 to impose a corporate level tax on the built-in gains recognized by former C corporations during the first 10 years of S election. To preserve equality, IRC §1374 provided offset for built-in gains with any built-in losses or net operating losses attributable to C corporation years.

5.2 TAXATION OF C CORPORATION GAINS V. S CORPORATION BUILT-IN GAINS TAX

A common misconception is that imposition of the built-in gains tax under IRC §1374 imposes more tax on an S corporation and its shareholders than if it had retained its C status. Congress' intent was to preserve equality between C corporations and those electing S status upon asset disposition.

The C Corporation generates a gain on the sale of an asset, pays the maximum corporate level tax, and distributes the proceeds, less tax paid at the corporate level, to its shareholder(s).
The S corporation generates a gain on the sale of an asset, pays the maximum corporate level tax on the portion attributable to prior C corporation years, and passes through the gain, less tax paid at the corporate level, to its shareholder(s).

A significant disadvantage of the built-in gains tax is that the gain becomes immediately taxable at both the S corporation and shareholder levels, whereas a C corporation can control the timing of distributions.

Example A

Total Tax Paid by C Corporation and Shareholder(s)

1.	Gain on asset sale	$100,000	
2.	Corporate tax @ 8.84% (beginning after 1/1/97)	8,840	$8,840
3.	Distribution to shareholders	91,160	
4.	**Shareholder tax @ 9.3%**	8,478	8,478
5.	Total tax paid		$17,318

Total Tax Paid by S Corporation and Shareholder(s)

1.	Gain on asset sale	$100,000	
2.	Built-in gain tax @ 8.84% (beginning after 1/1/97)	8,840	8.840
3.	Separately stated items per Schedule K-1:		
	Gain on asset sale	100,000	

	Built-in gains tax	-8,840	
	Subtotal	91,160	
4.	Shareholder tax @ 9.3%	8,478	8,478
5.	Total tax paid		$ 17,318

This example demonstrates that imposition of the built-in gains tax does not subject an S corporation and its shareholders to more tax than one that had remained a C corporation. The C Corporation, however, could have deferred declaration of the $91,160 distribution until future years.

5.3 EXAMINING THE BUILT-IN GAINS TAX ISSUE

When examining a built-in gains tax issue, the auditor should perform the steps provided below.

	Chapter Section
• Determine if the corporation is subject to the built-in gains tax.	5.4
• Determine if the tax year under examination is within the corporation's recognition period. In one situation, the ten-year recognition period begins when a C corporation elects to convert to an S corporation (IRC §1374(d)(7)). In another situation, the ten-year recognition period begins when an S corporation that is subject to the built-in gains tax acquires property with a carryover basis that was determined by reference to the basis in a C corporation, but only for purposes of determining the gain from such newly acquired asset. (IRC §1374(d)(8))	5.5
• Identify items of recognized built-in gain (loss).	5.6, 5.12 & 5.13
• Compute the "pre-limitation amount" (sum of recognized built-in gains, recognized built-in losses, recognized built-in gain carryovers, and IRC §1374 attributes).	5.7
• Determine if the taxable income limitation applies.	5.8
• Compute the "net unrealized built-in gain".	5.9
• Compute the "net recognized built-in gain".	5.10
• Determine the built-in gain tax deduction allowed at the shareholder level.	5.15

5.3.1 Glossary of Terms

The auditor should become familiar with commonly used terms when examining the built-in gain issue. The following terms are used frequently in reference material.

Recognized Built-in Gain	Any gain on asset disposition or item of income recognized (during the recognition period) that can be attributed to periods before the 1st taxable year for which the corporation was an S corporation or whose basis is determined by reference to a C corporation's basis. (For a detailed definition, see IRC §1374(d)(3).)
Recognized Built-in Loss	Any loss on asset disposition or item of deduction recognized (during the recognition period) that can be attributed to periods before the 1st taxable year for which the corporation was an S corporation or whose basis is determined by reference to a C corporation's basis.
Recognition Period	The period of time in which built-in gains tax can be assessed, generally 120 months beginning on the first day the corporation is an S corporation. A separate recognition period applies to an asset that is acquired by an S corporation from a C corporation, if the S corporation receives a carryover basis (in the asset) that is determined by reference to the C corporation transferor's basis in the same asset immediately before the transfer.
Net Recognized Built-in Gain	The maximum amount subject to the built-in gains tax during the tax year computed by using the lesser of the: (1) pre-limitation amount; (2) taxable income limitation; or (3) net unrealized built-in gain limitation. (Treas. Reg. §1.1374-2(a))

Pre-Limitation Amount	The S corporation's taxable income determined by using all rules applying to C corporations and considering only its recognized built-in gain, recognized built-in loss, recognized built-in gain carryover, and IRC §1374 attributes.
IRC § 1374 Attributes	IRC §1374 attributes are carryovers from C corporation years allowed to reduce recognized built-in gains and the built-in gains tax. For federal purposes, IRC §1374 attributes include (1) net operating and capital loss carryovers from C corporation years and (2) general business and AMT credit carryovers from C corporation years. For California purposes, IRC §1374 attributes include net operating and capital loss carryovers from C corporation years. R&TC 23809(b) does not allow credit carryovers to reduce built-in gains tax. In an unpublished decision in the Appeal of Don McComas Enterprises, Inc., Cal. St. Bd. Of Equal., April 19, 2001, the State Board of Equalization confirmed that deduction against built-in gains for net operating losses for losses an S corporation accumulated while it was a C corporation, is limited by R&TC §24416.
Taxable Income Limitation	The S corporation's taxable income determined by using all rules applying to C corporations, disregarding net operating loss carryovers and certain deductible dividends.
Net Unrealized Built-in Gain	The amount of gain the corporation would have realized if it remained a C corporation and disposed of all its assets at fair market value on the first day of the recognition period; increased by any recognized built-in loss that would not be allowed as a deduction under IRC §382, IRC

§383, or IRC §384, and any IRC §481 adjustments; and reduced by: (1) any liabilities that would have been included in the amount realized, if payment of the liability would have given rise to a deduction; (2) the corporation's adjusted basis in the assets immediately before the constructive sale; and (3) the corporation's IRC §481 adjustments.

5.4 CORPORATIONS SUBJECT TO THE BUILT-IN GAINS TAX

5.4.1 General Rule

The built-in gains tax is applicable to corporations that convert from C status to S status. Generally, the recognition period begins on the first day of the corporation's first taxable year for which the S election is effective. However, there are exceptions.

Exception #1

For taxable years beginning on or after January 1, 2002, California no longer allows a taxpayer who is a Federal S Corporation to be a California C Corporation. Therefore, a corporation with a valid Federal S Corporation election will be considered an S Corporation for California purposes. (R&TC §23801)

The 10 year recognition period for these corporations will be the same as for federal purpose (R&TC 23809(d)) even though they corporation just became an S-Corporation for state purpose.

Additionally, it should be noted that even though the valuation date for BIG purposes is the same as federal, the calculation of the BIG may be different for state purpose because of the difference in state and federal basis of the asset disposed of.

Example 1- No BIG

B2 Corp. (a calendar year taxpayer) was incorporated in 1970. As of 1/1/1991, B2 Corp. filed as an S Corporation for federal purposes, but continued to file as a C Corporation for California. In 2002, B2 Corp. was forced to convert to an S Corporation for California purposes.

On the date of the California S conversion (1/1/02) the taxpayer had land with a cost basis of $250,000 and a Fair Market Value (FMV) of $550,000.

In tax year 12/03, B2 Corp. sold land for $700,000. On the 12/03 return, B2 Corp. reported a capital gain of $450,000 ($700,000 (sales price) - $250,000(basis)).

There is no built-in-gain on the sale of the land because the property was sold after the federal recognition period ended on 12/31/00.

Example 2 – Increased BIG

B2 Corp. owns real property with a basis of $300,000, for both California and Federal purposes. On 1/1/1998, B2 Corp. elects to be treated as an S Corporation for federal purposes. The FMV of the property is $450,000 on 1/1/1998. Therefore, the federal BIG is $150,000. On 1/1/2002, they are forced to convert to S status for California, when the city council for the city in which the property was located was considering changing the zoning on the property. Due to the potential zoning change, the FMV of the property was $400,000 on 1/1/2002.

Later, the city council voted not to change the zoning, and B2 Corp. sold the property for $500,000 on 1/1/2005. Under the prior law, the California BIG would be $100,000. However, under the new law, B2 Corp. will have a BIG of $150,000 for both federal and California purposes.

	Prior Law	New Law
Sales Price	$500,000	$500,000
Basis	($100,000)	($100,000)
Gain	$400,000	$400,000
Amount Subject to BIG	$100,000	$150,000

Example 3- Same Date with Different Basis

B2 Corp. converted to S Corporation status for federal purposes on 1/1/2000, but elected to continue C corporation status for California purposes. On 1/1/2002, B2 Corp. was forced to become a California S Corporation. B2 Corp. had a building with a FMV of $200,000 on 1/1/2000 (date of valuation for both federal and California purposes). On 1/1/2000, the building had a federal basis of $100,000 and a California basis of $150,000.

On March 30, 2004, B2 Corp. sold the building for $400,000. For federal purposes, the BIG tax is computed on a BIG of $100,000. For California purposes, the BIG tax is computed on a BIG of $50,000.

Exception #2 - Acquiring Built-in Gain Assets

Even if the corporation is otherwise not subject to the built-in gains tax, it may become subject to the tax on the assets it acquires through (1) a tax-free merger with a C corporation or former C corporation, and/or (2) an exchange/conversion whereby the basis was determined by reference to unrecognized built-in gain (i.e. - like/kind exchanges, involuntary conversions).

5.4.2 Summary of Valuation Dates

Effective Date of CA Election	Valuation Date for BIG Computation
Before 1/1/2002	Use the California S election date to determine the 10-year recognition period, and the valuation for the BIG computation.
On or After 1/1/2002	• Check if there was a valid federal S Corp. election before 1/1/2002 (Federal S and California C Corp. prior to 1/1/2002), if so, use

the federal election date. (R&TC §23809(d)(1))

- If there was no Federal S election prior to 1/1/2002, then use California election date (federal election date must be the same).

5.5 RECOGNITION PERIOD

5.5.1 General Recognition Period

The recognition period is the 10-year (120 month) period beginning on the first day the corporation is an S corporation. A short tax year, such as when a fiscal year S corporation changes to a calendar tax year, does not affect or reduce the recognition period. For example, if the first day of the recognition period is July 14, 2005, the last day of the recognition period is July 13, 2015.

In the event that the corporation terminates its S election (voluntarily or involuntarily) and later becomes an S corporation again, the recognition period from the first S election does not carryover. The recognition period begins on the first day of the first taxable year of the corporation's second S election.

5.5.2 Recognition Period - C Corporation Assets Acquired

If an S corporation acquires an asset in which the corporation's basis in such asset is determined (in whole or part) by reference to the basis of such asset in the hands of a C Corporation (IRC §1374(d)(8)), the 10-year recognition period begins on the date of asset acquisition.

Example A
Tax-free Merger with C corporation

ABC incorporates on 1/1/04 and immediately elects S status. On 1/1/06, a C corporation merges into ABC, an S corporation. The first day of the recognition period is 1/1/06. The last day of the recognition period is 12/31/15.

Example B

Tax-free Merger with S Corporation that is Subject to Built-in Gains Tax

ABC incorporates on 1/1/04 and immediately elects S status. XYZ (an S corporation) is subject to the built-in gains tax with its recognition period starting on 1/1/01. On 1/1/05, ABC acquires XYZ, pursuant to a tax-free merger. ABC's recognition period in regards to the assets acquired from XYZ begins on 1/1/01 and ends on 12/31/11.

Assume the same facts as above, except for XYZ’s recognition period started on 1/1/03. ABC's recognition period in regards to the assets acquired from XYZ begins on 1/1/03 and ends on 12/31/13.

5.5.3 Recognition Period - Like-Kind Exchanges and Involuntary Conversions

Unrecognized built-in gain attributable to an asset given up in a like-kind exchange or involuntary conversion attaches to the new asset if the basis of the new asset is determined, in whole or part, by reference to the basis of the exchanged asset. (IRC §1374(d)(6)). The 10-year recognition period continues to be measured from the date of the S election, not from the date of exchange.

5.6 ITEMS OF BUILT-IN GAIN (LOSS)

In general, a built-in gain (loss) is triggered by the disposition of an asset that was on hand at the time the S election became effective, if the adjusted basis and the fair market value of the asset differed at the time the S election became effective. Following are examples of asset dispositions triggering a built-in gain (loss).

- Disposition of land, buildings, and depreciable assets.
- Disposition of assets acquired from a C corporation or former C corporation through merger after becoming an S corporation.
- Collection of accounts receivable, less expenses incurred to collect such receivables, by a cash-basis taxpayer.
- Disposition of assets acquired through exchange/conversion.
- Distribution of appreciated assets to a shareholder.
- Collection of an installment sale entered into prior to the date of conversion.
- Collection of an installment sale entered into after the date of conversion where the asset was held at the date of conversion.
- Sale of inventory (i.e. - LIFO recapture).
- Sale of goodwill (but not covenant-not-to-compete).
- S corporation’s pro rata share of gain (loss) from partnership asset dispositions.
- Sale of partnership interests.
- IRC §481(a) adjustments.
- Income received under the completed contract method.
- Liabilities incurred during the C corporation period deductible by the S corporation (i.e. - payment of accounts payable and accrued bonuses by a cash basis taxpayer).
- Payments made pursuant to a legal settlement.
- Receipt of income pursuant to a legal settlement.
- Recovery of bad debts.
- Income from discharge of indebtedness.

5.6.1 Definition of “Recognized Built-in Gain” IRC §1374(d)(3)

5.6.2 Definition of “Recognized Built-in Loss” IRC §1374(d)(4)

5.6.1 Definition of "Recognized Built-in Gain"

IRC §1374(d)(3) defines "recognized built-in gain" as any gain recognized during the recognition period on the disposition of any asset except to the extent that the S corporation establishes that –

(A) Such asset was not held by the S corporation as of the beginning of the 1st taxable year for which it was an S corporation, or
(B) Such gain exceeds the excess (if any) of—
   i. The fair market value of such asset as of the beginning of such 1st taxable year, over
   ii. The adjusted basis of the asset as of such time.

5.6.2 Definition of "Recognized Built-in Loss"

IRC §1374(d)(4) defines "recognized built-in loss" as any loss recognized during the recognition period on the disposition of any asset to the extent that the S corporation establishes that -

(A) Such asset was held by the S corporation as of the beginning of the 1st taxable year referred to in paragraph (3), and
(B) Such loss does not exceed the excess of
   (i) The adjusted basis of such asset as of the beginning of such 1st taxable year, over
   (ii) The fair market value of such asset as of such time.

5.6.3 Items of Built-in Gain (Loss) - Final Regulations §1.1374-4

Proposed regulations under IRC §1374, published in the Federal Register on December 8, 1992, provided special rules for certain items of built-in gain (loss) including an S Corporation's IRC §481 adjustments, income reported under the completed contract method, income reported under the installment method, and distributive share partnership items.

On December 27, 1994, after consideration of public comments regarding the proposed regulations, the Internal Revenue Service issued final regulations under IRC §1374 relating to the tax imposed on an S corporation's net recognized built-in gain.

Final regulations are applicable to taxable years ending on or after December 27, 1994, but only in cases where the return for the taxable year is filed pursuant to an S election or an IRC §1374(d)(8) transaction occurring on or after December 27, 1994.

NOTE: The final regulations should be applied to taxable years ending prior to December 27, 1994, unless legislation has taken a contrary position**.** (See Argo Sales Company, Inc. v. CIR (1995) 105 T.C. 86, in which the Tax Court held that, even though 26 C.F.R. part 1.1374-4(d) was not in effect for the years at issue, the taxpayer's IRC §481(a) adjustments were items of income attributable to periods before the first year for which the corporation was an S corporation and were properly treated as recognized built-in gain. See also Rondy, Inc. v. Comr., T.C. Memo 1995-372. See Reg. §1.1374-4(d)(1). See also H.R. Rep. No. 795, 100th Cong., 2d Sess. 63 (1988). Although IRC §481 adjustments are not specifically referenced under IRC §1374 tax discussion in the House Report, they are referenced in the same report (p. 46) where the IRC §382 built-in gain rules are explained. See also S. Rep. No. 445, 100^{th} Cong., 2d Sess. 48 (1988), for a reference to IRC §481 adjustments as built-in gain under IRC §382.)

The remainder of this section discusses the rules presented in the final regulations.

a. Sales and Exchanges (Treas. Reg. §1.1374-4(a))

A transaction resulting in a gain or loss recognized during the recognition period must qualify as a sale or exchange for federal income tax purposes.

b. Accrual Method Rule (Treas. Reg. §§1.1374-4(b)(1) and (2))

Treas. Reg. §1.1374-4(b)(1) provides that "any item of income properly taken into account during the recognition period is recognized built-in gain if the item would have been properly included in gross income before the beginning of the recognition period by an accrual method taxpayer."

To be treated as "recognized built-in loss", the item of deduction would have to be an allowable deduction against gross income before the beginning of the recognition period to an accrual method taxpayer. The following items are not considered items of deduction for built-in loss purposes: IRC §461(h)(2)(C) and Treas. Reg. §1.461-4(g) - liabilities for tort, worker's compensation, breach of contract, violation of law, rebates, refunds, awards, prizes, jackpots, insurance contracts, warranty contracts, service contracts, taxes, and other liabilities.

Example A

Accounts Receivable, Cash Basis S Corporation

ABC, Inc., a cash basis taxpayer, elected S status on 1/1/04.
On this date, it had accounts receivable for services rendered as follows:

Book value	$200,000
Fair market value	$150,000
Adjusted basis	$0

Accounts Receivable Collected During 2004
During 2004, it collected all of the $200,000. ABC would report a recognized built-in gain of $200,000 because it would have been included in gross income before the beginning of the recognition period if ABC had been an accrual basis taxpayer.

Accounts Receivable Sold or Exchanged During 2004
If ABC had disposed of the accounts receivable for $150,000 in 2004 in a transaction treated as a sale or exchange for federal income tax purposes, it would have recognized built-in gain of $150,000 ($150,000 - 0) on the disposition.

Example B

Contingent Liability, Cash Basis S Corporation - Lawsuit
ABC, Inc., a cash basis taxpayer, elected S status on 1/1/04.
In 2003, a lawsuit was filed against ABC claiming damages for $10,000,000. The lawsuit was settled in 2004.

ABC paid damage awards of $5,000,000 that it deducted on its 2004 return. The $5,000,000 payment is not a recognized built-in loss because it would not have been deductible before the beginning of the recognition period if ABC had been an accrual basis taxpayer.

Example C

Deferred Payment Liabilities, Cash Basis S Corporation - Lawsuit
ABC, Inc., a cash basis taxpayer, elected S status on 1/1/04.
In 2003, ABC lost a lawsuit and became obligated to pay $10,000,000.
ABC paid the damage awards in 2004, which was deducted on its 2004 return (not allowed as a deduction until payment is made). The $10,000,000 payment is recognized built-in loss because it would have been deductible before the beginning of the recognition period if ABC had been an accrual basis taxpayer.

Example D

Deferred Prepayment Income, Accrual Basis S Corporation - Services Rendered
ABC, Inc., an accrual basis taxpayer, elected S status on 1/1/04.

In 2003, ABC received $50,000 for services to be rendered in 2004, and properly elected to include the $2,500 in gross income in 1996 under Rev. Proc. 71-21, 1971-2 C.B. 549

This income would not be considered a recognized built-in gain when ABC recognizes the $50,000 into income in 2004 because it would not have been included in gross income by an accrual method taxpayer using the method that ABC actually used before the beginning of the recognition period.

Example E

Change in Method, Accrual Basis S Corporation
ABC, Inc., an accrual basis taxpayer, elected S status on 1/1/04.

In 2003, ABC received $5,000 for services to be rendered in 2004 and properly included the $5,000 into income in 2003.

In 2004, ABC, Inc. elected an accounting method change to include the $5,000 into gross income in 2004, which resulted in an ($5,000) IRC §481(a) change in accounting method adjustment.

The $5,000 included into gross income in 2004 is recognized built-in gain because it would have been included in gross income using the method actually used before the beginning of the recognition period.

In addition, the IRC §481(a) change in accounting method adjustment of ($5,000) is recognized built-in loss because it relates to an item attributable to periods before the beginning of the recognition period.

The net recognized built-in gain is $0.

c. Deductions for Payments to Related Parties (Treas. Reg. §1.1374-4(c)(1))

Any amount properly deducted in the recognition period under IRC §267(a)(2), relating to payments to related parties, is recognized built-in loss to the extent:

- All events have occurred that established the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period, and

- The amount is paid (a) in the first 2½ months of the recognition period or (b) to a related party owning, under the attribution rules of IRC §267, less than 5%, by voting power and value, of the corporation's stock, both as of the beginning of the recognition period and when the amount is paid.

d. Deductions for Payments for Deferred Compensation (Treas. Reg. §1.1374-4(c)(2))

Any amount properly deducted in the recognition period under IRC §404(a), relating to payments for deferred compensation, is recognized built-in loss to the extent:

- All events have occurred that established the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period, and
- The amount is not paid to a related party to which IRC §267(a)(2) applies.

e. IRC §481(a) Adjustments (Treas. Reg. §1.1374-4(d))

IRC §481(a) adjustments taken into account in the recognition period are recognized built-in gain or loss to the extent the adjustment relates to items attributable to periods before the beginning of the recognition period. IRC §481(a) adjustments regard changes in accounting methods to prevent omissions or duplications of income or deductions.

Example A

Omitted Item Attributable to Prerecognition Period
ABC, Inc. elects to become an S corporation effective 1/1/03.

ABC improperly capitalizes repair costs and recovers the costs through depreciation of the related assets.

In 2006, ABC properly changes to deducting repair costs as they are incurred. Under IRC §481(a), the basis of the related assets are reduced by an amount equal to the excess of the repair costs incurred before the year of change over the repair costs recovered through depreciation before the year of change. The resulting IRC §481(a) adjustment is negative.

The IRC §481(a) adjustment relating to the repair costs incurred before the recognition period is recognized built-in loss because those repair costs are items attributable to periods before the beginning of the recognition period.

f. Discharge of Indebtedness and Bad Debts (Treas. Reg. §1.1374-4(f))

Any item of income or deduction properly taken into account during the first year of the recognition period as discharge of indebtedness income under IRC §61(a)(12) or as a bad debt deduction under IRC §166 is recognized built-in gain or loss if the item arises from a debt owed by or to an S corporation at the beginning of the recognition period.

g. Completion of Contract (Treas. Reg. §1.1374-4(g))

Any item of income properly taken into account during the recognition period under the completed contract method (Treas. Reg. §1.460-4(d)) where the corporation began performance of the contract before the beginning of the recognition period is recognized built-in gain if the item would have been included in gross income before the beginning of the recognition period under the percentage of completion method

(Treas. Reg. §1.460-4(b)). Any similar item of deduction is recognized built-in loss if the item would have been allowed as a deduction against gross income before the beginning of the recognition period under the percentage of completion method.

h. Installment Method (Treas. Reg. §1.1374-4(h))

In general, if a corporation sells an asset before or during the recognition period and reports the income from the sale using the installment method under IRC §453, that income is an item of built-in gain. The final regulations have provided special treatment for income received on the installment method. Please refer to Section 5.12 - Special Rules for Installment Reporting.

i. Partnership Interests (Treas. Reg. §1.1374-4(i))

In general, an S corporation owing an interest in a partnership must treat its distributive share of the partnership's items as recognized built-in gain or loss to the extent the S corporation's distributive share would have been treated as recognized built-in gains or loss if the items originated in, and were taken into account directly by the S Corporation (the "look-through rule"). The final regulations have provided special rules for determining the items of built-in gains (losses) in regards to partnerships. Please refer to Section 5.13 - Special Rules for Partnership Interests.

j. Valuing and Disposing of Inventory (Treas. Reg. §1.1374-7)

The value of an S Corporation's inventory on the first day of the recognition period generally is determined by reference to a sale of the entire business of the S Corporation to a buyer that expects to continue to operate that business. The buyer and seller are presumed not to be under any compulsion to buy or sell and to have reasonable knowledge of all relevant facts such as:

- The replacement cost of the inventory,

- The expected retail selling price of the inventory,
- The seller's incentive to demand a price for the inventory that would compensate for and provide a fair return for expenditures the seller incurred to obtain, prepare, carry, and dispose of the inventory before the sale of the business, and
- The buyer's incentive to pay a price for the inventory that would compensate for and provide a fair return for similar expenditures the buyer expects to incur after the sale of the business.

The inventory method used by an S corporation for tax purposes must be used to identify whether the inventory it disposes of during the recognition period is inventory it held on the first day of that period. Thus, a corporation using the LIFO method does not dispose of inventory it held on the first day of the recognition period unless the carrying value of its inventory for a taxable year during that period is less than the carrying value of its inventory on the first day of the recognition period (determined using the LIFO method as described in IRC §472).

However, if a corporation changes its method of accounting for inventory (for example, from the FIFO method to the LIFO method or from the LIFO method to the FIFO method) with a principal purpose of avoiding the tax imposed under IRC §1374, it must use its former method to identify its dispositions of inventory. In Reliable Steel Fabricators, Inc. v. Comr. (1995) T.C. Memo 1995-293, the Tax Court held that, for purposes of determining the taxpayer's recognized built-in gain, work-in-process is valued at a discount from retail. In determining what a willing buyer would pay a willing seller for its work-in-process, the fair market value was lower than full retail price but higher than cost since a willing buyer would not forgo all profit inherent in the inventory and a willing seller would not forgo all profit inherent in the work-in-process.

5.6.4 Valuations

Per IRC §1374(d)(3), the "recognized built-in gain amount" is the gain recognized during the 10-year recognition period except to the extent the corporation establishes that the gain occurred after the effective date of the S-election. As a result, valuations are frequently provided by corporations to support fair market values as of the effective date for the S-election. Thus, an understanding of various valuation methods can be critical to resolving BIG cases.

The most widely used methods are listed below in their general order of acceptability.

- Analysis of the Actual Sale
- Analysis of Comparable Companies
- Discounted Cash-flow Method
- Excess Earning Method

A description of each of these methods along with examples follows.

Caution: Examples are provided to illustrate possible uses of each of the above methods. The examples are not intended as definitive guidelines for how to employ each method.

Comprehensive example

Except for the Excess Earnings method, the valuation methods mentioned above are generally used to derive a fair market value (FMV) for a company's equity. For BIG purposes, the question is usually the FMV of the company's assets. The following is an example showing how the FMV of a company's assets might be computed once a value for the company's equity has been derived.

Key concept:

The FMV of a company's assets = The FMV of its liabilities + The FMV of its equity

If we have determined that the FMV of a company's equity is $5 million and a review of its balance sheet reveals liabilities totaling $2 million, the FMV of the company's assets is $7 million. An example will be used to illustrate how the FMV of the individual asset groups can be estimated. Generally, current assets have FMVs that are similar to their book values and non-current assets frequently have FMVs that are substantially different from book values.

Example A

Don Company is in the business of manufacturing and selling widgets. The company operated as a C-corporation for ten years prior to electing S-status. The company's assets are sold in a complete liquidation three years after the S-election date. Based upon an analysis of the company, the FMV of its equity on the date its S-election became effective is estimated at $6 million. In addition, the company had $2 million of liabilities at the time (the book value of liabilities is assumed to be FMV). Thus, the FMV of Don's total assets are estimated to have been $8 million (6 + 2). Finally, the company's assets were reported on its books as follows:

Cash	$500,000
A/R	$1,000,000
N/R from shareholder	$300,000
Inventory (at cost)	$1,000,000
Equipment (net book)	$1,500,000

Assume that it cost the company $1 to make a widget and that it sells the widget for $2. In addition, assume that an analysis of the actual asset reveals that the equipment was sold for approximately book value.

In the absence of other information, it may be reasonable to estimate the value of the various assets as follows.

Cash	The FMV of cash would be the same as book.
A/R	Accounts receivable would usually have a fair market value that is less than book value due to uncollectible accounts, the costs of collection and the time value of money. Without detailed knowledge concerning the quality of the accounts a 10% discount from book value would probably be reasonable.
N/R	The FMV of the loan to the shareholder would depend on the terms of the loan, the quality of any security and current market rates for similar loans. If the loan has a below market interest (as we will assume and as is quite

common), a discount from book value would be warranted. Thus, a 20% discount from book will be applied to estimate FMV.

Inventory — There are special rules that apply when valuing inventory for BIG purposes. Per Treas. Reg. §1.1374-7, "the fair market value of the inventory of an S corporation on the first day of the recognition period equals the amount that a willing buyer would pay a willing seller for the inventory in a purchase of all the S corporation's assets by a buyer that expects to continue to operate the S corporation's business". In addition, the preamble to Treasury Decision 8579 states, "the value of inventory will usually be less than its anticipated retail price but more than its replacement cost". In this example, the markup between cost and retail is 100%. Thus, absent additional information, it may reasonable to estimate the FMV of inventory at cost plus 50%.

Equipment — An analysis of the subsequent actual sale revealed that the equipment sold for approximately book value. An actual sale that is reasonably proximate to the valuation date is usually a good indicator of FMV. Thus, it is probably reasonable to estimate the FMV of the equipment on the date the S-election became effective to be the same as book value.

Goodwill — The FMV of goodwill is equal to the value of total assets minus the values previously allocated to other assets.

Based upon the above, the estimated FMV of the company's assets on the valuation date is as follows.

Cash	$500K
A/R	$900K
N/R	$250K
Inventory	$1,500K
Equipment	$1,500K
Goodwill	$3,350K

Note: The total FMV of the company's assets is $8 million.

CAUTION: This approach may or may not be reasonable depending on the volatility of the values of the various asset classes and materiality. The example is presented as a possible approach that may be reasonable under certain circumstances and to illustrate an approach.

- **Actual Sales Method**

Analysis of the Actual Sale – This approach is based on the thought that the best indicator of the value of a business is an actual sale of the business, particularly when the sale is proximate in time to the valuation date. (See Jung Est. v. Comm., (1993) 58 TCM 1127, Morris v. Comm., (1978) 70 TC 959; Narver v. Comm., 75 TC 53.) Using this approach, an analysis of the actual sale is made and the data gained from this analysis is then applied to the facts that existed on the valuation date to determine a FMV.

If the actual sale is only a few months after the valuation date and no material events occurred in the interim, it may be reasonable to use the actual sales price as the estimate of FMV on the valuation date. If the actual sale date is somewhat removed from the valuation date, adjustments can be made to the derived value to account for material events that occurred between the valuation date and the sale date to derive a FMV.

Example A

A company elects S status on 7/1 and, then, it is sold on 8/1 to an unrelated party. If there was no material event between 7/1 and 8/1, the actual sales price is the best indicator of the company's value on 7/1.

Example B

J corporation elects S status on 1/1/04 and the business is sold on 1/1/05. An analysis of the terms of the actual sale may be a sound method for estimating the value of the corporation on the S-election date.

Pertinent facts are as follows:
The corporation sold all of its assets for $20 million in cash.

The corporation's sales in FYE 12/00 were $10 million and its ordinary income from operations for the year was $1 million. In FYE 12/03, its sales were $8 million and its ordinary income from operations was $1 million.

J corporation was 100% owned by an individual who also worked for the corporation. The corporation paid this individual a salary of $1 million in FYE 12/04 and a salary of $700K in FYE 12/03.

In the years preceding the S-election, its sales had steadily grown at a 25% annual rate.

(Note: Because the sole shareholder also draws a salary from the corporation and because the amount paid to the shareholder is discretionary, an adjustment is made to the ordinary income amount to reflect the disallowance of the salary paid to the shareholder. This adjustment is made only to derive a valuation multiple. As a result, the corporation's adjusted ordinary income from operations is $2 million)

Based on the above facts, the corporation sold for two times its prior year's sales ($20 million/$10 million) and 10 times its adjusted ordinary income from operations ($20 million/ $2 million). If these multiples are applied to the figures for FYE 12/03, the following unadjusted value is derived.

Value based on sales multiple – Based on a sales multiple of two, the corporation would have a value of $16 million (2 x $8 million) on 1/1/04.

Value based on adjusted ordinary income multiple – The corporation's adjusted ordinary income for FYE 12/03 is $1.7 million ($1,000,000 + $700,000). Based on the derived multiple of ten, a value of $17 million is obtained.

If these two values are averaged, an unadjusted value of $16.5 million is obtained. However, it may be advisable to adjust this value for events that occurred between the valuation date and the sale date such as a strong stock market, a substantial change in prevailing interest rate, a change in the company's growth prospects, etc. In this example, the company's sales continued to grow at a 25% rate so no adjustment is needed for a change in its growth. However, it may be advisable to make adjustments for events in the economy as a whole. For example, if valuation multiples in the economy are up significantly as evidenced by the stock market indexes being up significantly in the period between the valuation date and the sale, it may be reasonable to make an adjustment for this occurrence.

In the above example, if the Standard & Poor's 500 index increased significantly in 2004. It may be reasonable to adjust the $16.5 million value to account for an expansion in valuation multiples.

Example C

Gold Bug Mining is in the gold production business. The company has operated for many years as a "C" corporation and then it elects "S" status. Ten months after electing "S" status, the company is sold for $50 million. In determining the FMV of the company as of the S-election date, you notice that gold stocks appreciated dramatically (P/E ratios for many stocks in the industry doubled) between the S-election date and the actual sale date. Thus, you should probably account for this change in your valuation.

- **The Comparable Sales Approach**

Overview – With the comparable sales approach, the value of the subject company is derived from the valuations of similar companies in the same or similar line of business. Support for this approach can be found in both Revenue Rulings 59-60 and 80-233 along with numerous court cases. (See Newhouse Est. v. Comm., (1990) 94 T.C. 193 or Lauder Est. v. Comm., (1994) 68 T.C.M. 985.) In the comparable sales approach, an analysis of publicly traded companies is made to determine valuation multiples that can then be applied to a non-publicly traded stock. Per Rev. Rul. 59-60, stock listed on an exchange is to be considered first and over-the-counter stock second for comparison purposes.

Example A

XYZ Computer incorporated in 1987 and it elected S status on 4/1/01. On 1/1/05, the corporation was sold to a third party for $40 million. XYZ's primary product throughout its existence was high-end personal computers. XYZ's sales in FYE 3/01 were $8 million and its net income for FYE 3/01 was $500K.

Based on the comparable sales method, the value of XYZ on 4/1/01 was estimated as follows.

A list of companies in the same or similar line of business is obtained and an analysis of the selected companies is undertaken to derive valuation multiples and financial data.

The valuation multiples of the reference companies are analyzed in light of their financial performances and trends.

Valuation multiples derived from the analysis of the comparable companies are applied to the subject company to derive an estimate of its FMV on the valuation date.

Presented below is selected data for XYZ and the reference companies.

Data on XYZ and Reference Companies

1) XYZ Computer – In the spring of 2001, XYZ's main business was the designing, assembling and marketing of high-end portable computers for business.
   Sales Growth: FYE 3/99 = 75%, FYE 3/00 = 82%, FYE 3/01 = 148%
   Gross Margin: FYE 3/99 = 38%, FYE 3/00 = 32%, FYE 3/01 = 36%
   Net Income/Sales: FYE 3/99 = <7.7%>, FYE 3/00 = <5.2%>, FYE 3/01 = 5.7%

2) ABC Computer– ABC develops, manufactures and markets personal computer systems for a wide array of markets. For FYE 9/01, the company had sales of $6.3 billion.
   a) Sales Growth: FYE 9/99 = 30%, FYE 9/00 = 5%, FYE 9/01 = 14%
   b) Gross Margins: FYE 9/99 = 49%, FYE 9/00 = 53%, FYE 9/01 = 47%

c) Net Income/Sales: FYE 9/99 = 8.6%, FYE 9/00 = 8.5%, FYE 9/01 = 4.9%
d) Closing Price on 4/1/01 = $68.50
e) EPS for FYE 9/00 = $3.77
f) P/E ratio based on FYE 9/00 EPS = 18 ($68.50 / $3.77)
g) Sales/Share in FYE 9/00 (based on avg. # of shares in FYE 9/00) = $44.18 ($5,558,435 / 125,813)(000's omitted)
h) Price/Sales based on sales in FYE 9/00 = 1.6 ($68.50 / $44.18)

Analysis: ABC's sales growth in the period around 4/1/01 is substantially below that of XYZ's. However, its gross margin is somewhat better and its Net Income/Sales ratio about the same as XYZ's. Based on these factors, XYZ's valuation multiples would probably be higher than ABC's due to the upward trend in its sales growth rate and its much higher growth rate.

3) DEF Computer– DEF designs, manufactures and direct markets personal computers and computer accessories. For FYE 2/3/01, the company had sales of $546 million.

Sales Growth: FYE 1/99 = 62%, FYE 1/00 = 51%, FYE 1/01 = 41%
Gross Margins: FYE 1/99 = 31%, FYE 1/00 = 28%, FYE 1/01 = 33%
Net Income/Sales: FYE 1/99 = 5.6%, FYE 1/00 = 1.3%, FYE 1/01 = 5.0%
Closing Price on 4/1/01 = $28.625
EPS for FYE 2/3/01 = $.91
P/E based on EPS for FYE 2/3/01 = 31 ($28.625 / $.91)
Sales/Share in FYE 2/3/01 = $18.17 ($546,235 / 30,063)
Price/Sales based on sales in FYE 2/3/01 = 1.6 ($28.625 / $18.17)

Analysis: DEF's sales growth is significantly below XYZ's for the period nearest 4/1/01 (41% vs. 148%) and its sales growth rate has been in decline each of the above years. However, both its gross margin and Net Income/Sales ratios are comparable to XYZ's. Thus, XYZ's valuation multiples would probably be higher than DEF's due to a better trend in its sales growth and the much higher growth rate.

4) GHI Computer– GHI designs, manufactures and markets personal computers and related products. In 2001, it was the third largest maker of personal computers. For FYE 12/00, CPQ had total sales of almost $3.6 billion.

Sales Growth: FYE 12/98 = 69%, FYE 12/99 = 39%, FYE 12/00 = 25%
Gross Margins: FYE 12/98 = 40%, FYE 12/99 = 40%, FYE 12/00 = 42%
Net Income/Sales: FYE 12/98 = 12.4%, FYE 12/99 = 11.6%, FYE 12/00 = 12.6%
Closing price on 4/1/01 = $61.625
EPS for FYE 12/00 = $5.14
P/E based on EPS for FYE 12/00 = 12 ($61.625 / $5.14)
Sales/Share for FYE 12/00 = $41.80 ($3,598,800 / 86,090) (000's omitted)
Price/Sales based on sales in FYE 12/00 = 1.5 ($61.625 / $41.80)

Analysis: GHI's sales growth in the fiscal year ending closest to 4/1/01 was well below that of XYZ's (25% vs. 148%). In addition, the trend for sales growth was decidedly downward. However, its Net Income/Sales ratio is well above XYZ's and its gross margins are similar to XYZ's. Based on these factors, it would be reasonable for XYZ to have higher valuation multiples than GHI because it has a better trend in sales growth and a higher sales growth rate.

5) JKL Inc. – JKL designs, manufactures and markets array processors, which are small, special purpose computers. For FYE 8/00, JKL had sales of $11.3 million.

Sales Growth: FYE 8/98 = 2%, FYE 8/99 = 26%, FYE 8/00 = <6%>
Gross Margins: FYE 8/98 = 66%, FYE 8/99 = 63%, FYE 8/00 = 65%
Net Income/Sales: FYE 8/98 = 2.7%, FYE 8/99 = 7.2%, FYE 8/00 = 7.4%
Closing price on 4/1/01 = $6.375
EPS for FYE 8/00 = $.31
P/E based on EPS for FYE 8/0 = 21 ($6.375 / $.31)
Sales/Share in FYE 8/00 = $4.13 ($11,298,000 / 2,733,000)
Price/Sales based on sales in FYE 8/00 = 1.5 ($6.375 / $4.13)

Analysis: JKL's sales growth in the period ending closest to 4/1/91 was a negative 6% vs. a positive 148% for XYZ. However, JKL's gross margin and Net Income/Sales were better than XYZ's. Based on these factors, XYZ's valuation multiples could reasonably be expected to be higher than JKL's due to its better trend in sales growth and its much higher sales growth rate.

Summary

Price/Earnings Multiple – The P/E multiples for the reference companies range from 12 to 31. The average is 20.5 and the median is 19.5.

Price/Sales Multiple – The range for this multiple is 1.5 to 1.6 with 1.55 as both the average and the median value.

Sales Growth – The sales growth rates for the reference companies range from a negative 6% for JKL to a positive 41% for DEF. The average and the median value for the reference companies is 15%.

Based upon our analysis of the above reference companies, it appears that a P/E multiple of 24 and a Price/Sales multiple of 2 seem reasonable for XYZ on 4/1/01. These multiples are above most of the reference companies. The premium is attributed to the fact the XYZ's sales growth rate is vastly higher than any of the reference companies and it has been able to achieve its growth while maintaining stable gross margins.

Applying these multiples to XYZ's FYE 3/01 net income and the company's FYE 3/01 sales, the following values are derived.
P/E value = $500,000 x 24 = $12,000,000
Price / Sales value = $8,000,000 x 2 = $16,000,000
Averaging the two values, a value of $14,000,000 is obtained.

TIPS:

Lists of publicly traded companies in the same or similar industry can readily be found at numerous sites on the internet (i.e. Yahoo/Finance).

Data sources for the reference companies include ValueLine (at the public library) and Moody's along with various other sites or publications. Great care must be used in the analysis to make sure that the data is all adjusted for stock splits or stock dividends. ValueLine's data is all split adjusted and on a per share basis.

- **Discounts and Premiums**

When the value of a privately held company is derived from the values of publicly held companies, several adjustments to the derived value may be warranted. Two frequently cited adjustments are a premium for control and a discount for lack of marketability. A brief discussion of each is follows.

1) Control Premium

In the comparable sales method, the prices used are from sales of minority interests in publicly traded stocks. Thus, the prices do not reflect the value of the right to control a corporation since such right is usually not inherent in such a trade. The right to control a corporation has significant value. Therefore, a premium to the unadjusted value that was derived from an analysis of publicly traded companies is usually needed.

In "Valuing a Business" by Pratt, Reilly and Schweihs, several studies on control premiums are cited. Most of the studies tend to support premiums in the 25 – 40% range. Thus, an appraisal citing a premium significantly outside this range should be closely reviewed.

Factors affecting the size of the control premium include:

- The rights of minority shareholders
- The perceived quality of the company's management
- The perceived efficiency of current operations

Obviously, these are highly subjective criteria. Thus, detailed analysis is very difficult.

2) Discount for Lack of Marketability

When the value of a privately held company is derived from the values of publicly-traded companies, a discount to the derived value is typically warranted to reflect the fact that shares in the non-publicly traded companies are not readily marketable. This discount is necessary because, everything else being equal, investors prefer liquid investments. Several widely cited studies concerning this issue have supported discounts in the 30 – 40% range.

In Bernard Mandelbaum, et al. v. Comm., TC Memo 1995-255, the court discusses several of these studies and, then, goes on to state the following:

"Ascertaining the appropriate discount for limited marketability is a factual determination. Critical to this determination is an appreciation of the fundamental elements of value that are used by an investor in making his or her investment decision. A nonexclusive list of these factors includes: (1) The value of the subject corporation's privately traded securities vis-à-vis its publicly traded securities (or, if the subject corporation does not have stock that is traded both publicly and privately, the cost of a similar corporation's public and private stock); (2) an analysis of the subject corporation's financial statements; (3) the corporation's dividend-paying capacity, its history of paying dividends, and the amount of its prior dividends; (4) the nature of the corporation, its history, its position in the industry, and its economic outlook; (5) the corporation's management; (6) the degree of control transferred with the block of stock to be valued; (7) any restriction on the transferability of the corporation's stock; (8) the period of time for which an investor must hold the subject stock to realize a sufficient profit; (9) the corporation's redemption policy; and (10) the cost of effectuating a public offering of the stock to be valued, e.g., legal, accounting, and underwriting fees. See Estate of Gilford v. Commissioner,(1987), 88 T.C. 38, 60; Northern Trust Co. v. Commissioner, (1986), 87 T.C. 349, 383-389; see also Rev. Rul. 77-287, 1977-2 C.B. 319 (valuation of restricted securities)."

If you are working this issue, it is strongly suggested that you review the court's discussion of these factors. Additional information on this issue can be found in the book "Valuing a Business" by Pratt, Reilly and Schweihs and Rev. Rul. 77-287.

- **The Discounted Cash-Flow Method (DCF)**

Overview – The DCF method is typically used when no actual sale is available and no comparable companies can be found. With the discounted cash-flow method, the value of a company is the discounted value of its expected future cash flows. This method requires an estimation of the future cash flows associated with company and then the application of an appropriate discount rate given the risks associated with the cash flows and the level of interest rates in the economy. Great care must be taken when projecting the cash flows and even greater care must be exercised in selecting an appropriate discount rate. The discount rate selected can substantially affect the computed value. Cases supporting the use of this method include Northern Trust Co. v. Comm., (1986) 87 TC 349 and Est. of Cartwright v. Comm., TC Memo 1996-286.

Example: What is the present value of ten annual payments of $100K that starts one year from today assuming discount rates of 18% and 24%?

The answer is obtained by multiplying the annual payment amount by the present value interest factor for an annuity (PVIFA) for the stated rate and number of periods. Present value tables can be found in most finance and accounting books. At an 18% discount rate, the value is $449,410 ($100K x 4.4941). At 24%, the value declines to $368,190 ($100K x 3.6819).

The company's cash flows can be reasonably estimated based upon an analysis of financial statements for the years preceding the valuation date. In addition, an analysis of prior years financial statements will probably aid in predicting the expected growth in cash flows.

Example A

Based on a review of the company's financial statements for several years preceding the valuation date, the following assumptions are made in order to project future cash flows.

Sales in the year following the valuation date are projected to be $5 million and sales are expected to grow 20%/year.
Cash flow is expected to be 6% of sales during the forecast period.
The company is assumed to be sold at the end of the fifth year following the valuation date for 10 times cash flow. This assumption is based on the cash flow multiples in the industry at the valuation date.
A discount rate of 20% compounded annually is deemed appropriate.

COMPUTATION

Year	Cash-Flow Amt		P.V. Factor		Present Value
1	$300,000	x	.8333	=	$249,990
2	$330,000	x	.6944	=	$229,152
3	$363,000	x	.5787	=	$210,068
4	$399,300	x	.4823	=	$192,582
5	$439,230	x	.4019	=	$176,527
			TOTAL		**$1,058,319**

Terminal Value (TV) = 10 x $439,230 = $4,392,300
P.V. of TV = $4,392,300 x .4019 = $1,765,265
Total Present Value = $1,058,319 + $1,765,265 = $2,823,584
Thus, based on the assumptions specified, the company's value is estimated to be $2,823,584 as of the valuation date

1.) Variables in the DCF Method

The DCF method requires that various assumptions be made. Among the most important assumptions are:

- The projected annual cash flows
- The expected terminal value
- The appropriate discount rate

A brief discussion of each of these factors is provided below.

The projected annual cash flows – The DCF method requires that projections be made concerning a company's future cash flows. There are various definitions of cash flow available; however, most are some variation of the following:

Cash Flow = Net Income after taxes + Depreciation – Capital Expenditures

In the absence of information to the contrary, it may be reasonable to predict the future cash flows based on an analysis of the company's cash flows for several years preceding the valuation date. Support for this approach can be found in Rev. Rul. 59-60, Sec. 4.02(d).

The expected terminal value – In the DCF method, an expected future value of the company is frequently predicted so that there is an ending to the projected future cash flows. This terminal value is what the company is expected to sell for at some future date. It may be appropriate to project the expected terminal value based upon valuation multiples for the industry at the valuation date or the average valuation date at several points in time.

The discount rate – The discount rate is the expected rate of return an investor would require to invest in the company. The discount rate applied to the expected future cash flows is an extremely important variable. The value derived from this method is greatly altered from relatively minor changes in the discount rate. For example, if a 16% discount rate were used in the above example, the derived value would increase from $2,823,584 to $3,257,284. Conversely, if the discount rate were increased to 24%, the derived value would decrease to $2,463,915.

The appropriate discount rate can be derived in numerous ways. However, most approaches are usually some variation of the following.

Discount Rate = The risk-free interest rate on the valuation date + An equity risk premium + A risk premium for the specific company.

The risk-free rate is frequently the interest rate on treasury bills or treasury notes. The rate chosen should be based on the prevailing rates on the valuation date. Historical data on treasury securities can be found at many Internet sites including Yahoo/Finance or www.federalreserve.gov .

The equity risk premium is the additional return required to invest in equities instead of the risk-free investment. Frequently, this premium is based on long-term studies of the returns from different securities markets. A premium in the 5-8% range is very common. Many studies are based on data from Ibbotson Associates. The premium used is usually based on comparing the long-term returns from a stock index (i.e. the S&P 500) to the returns from treasury securities. In other words, most of these studies conclude that the rate of return from stocks has usually been 5-8% greater per year than the return from treasury securities.

The risk premium for the specific company can vary widely. The factors cited for the figure selected may include:

- The size of the company.
- The financial strength of the company.
- The degree of leverage used by the company.
- The products produced by the company.
- The company's number of customers.

The company specific risk premium is frequently in the 6-12% range. A premium greater than 12% may require close scrutiny.

Example B

If the interest rate on 6 month treasury bills is 6%, the discount rate applicable to a well-established small grocery chain that has little debt in its capital structure, a long history of stable sales growth and is situated in a moderate-sized town with a diverse economic base may be computed as follows.

The risk-free rate	6%
The equity risk premium	7%
The company specific risk premium	6%
	19%

Discount Rate
In this example, the rationale for selecting a relatively modest company specific risk premium could include the facts that – 1) The company is well-established 2) It has little debt 3) It has a long history of stable growth 4) The town has a diverse economic base 5) Groceries are necessities. All of these factors could indicate a below average specific risk premium is appropriate.

- **Excess Earnings Method**

The Excess Earnings method is also known as the formula method. It is not a recommended method but a summary of the method is presented because it is frequently used in appraisal reports provided by taxpayers. Per Rev. Rul. 68-609, the method "should not be used if there is better evidence available from which the value of intangibles can be determined…Accordingly, the formula approach may be used for determining the fair market value of intangible assets of a business only if there is no better basis therefore available."

Rev. Rul. 68-609 describes the Excess Earnings method as follows:

A percentage return on the average annual value of the tangible assets used in a business is determined, using a period of years (preferably not less than five) immediately prior to the valuation date. The amount of the percentage return on tangible assets, thus determined, is deducted from the average earnings of the business for such period and the remainder, if any, is considered to be the amount of the average annual earnings from the intangible assets of the business for the period. This amount (considered as the average annual earnings from intangibles), capitalized at a percentage of, say, 15 to 20 percent, is the value of the intangible assets of the business determined under the “formula” approach.

The percentage of return on the average annual value of the tangible assets used should be the percentage prevailing in the industry involved at the date of valuation, or (when the industry percentage is not available) a percentage of 8 to 10 percent may be used.

The 8 percent rate of return and the 15 percent rate of capitalization are applied to tangibles and intangibles, respectively, of businesses with a small risk factor and stable and regular earnings; the 10 percent rate of return and 20 percent rate of capitalization are applied to businesses in which the hazards of business are relatively high.

The above rates are used as examples and are not appropriate in all cases. In applying the “formula” approach, the average earnings period and the capitalization rates are dependent upon the facts pertinent thereto in each case.

The past earnings to which the formula is applied should fairly reflect the probable future earnings. Ordinarily, the period should not be less than five years, and abnormal years, whether above or below the average, should be eliminated. If the business is a sole proprietorship or partnership, there should be deducted from the earnings of the business a reasonable amount for services performed by the owner or partners engaged in the business. See Lloyd B. Sanderson Estate v. Commissioner,(1930), 42 F. 2d 160. Further, only the tangible assets entering into net worth, including accounts and bills receivable in excess of accounts and bills payable, are used for determining earnings on the tangible assets. Factors that influence the capitalization rate include (1) the nature of the business, (2) the risk involved, and (3) the stability or irregularity of earnings.

Example A

Based on a review of Joe Corporation's financial statements for the five years preceding the valuation date, the company is expected to have a net income of $2 million dollars a year for the foreseeable future. Furthermore, the value of its net tangible assets on the valuation date is $10 million. In addition, a fair rate of return on the tangible assets is estimated to be 10% and the capitalization rate for excess earnings is 15%. Thus, the value of the company's goodwill is estimated as follows.

Expected net income	2,000,000
Less: Returns attributable to net tangible assets (10% x $10,000,000)	1,000,000
Expected Excess Earnings	1,000,000
Capitalized Excess Earnings (i.e. goodwill)($1,000,000/15%)	6,666,667

Thus, the total value of the company’s tangible and intangible assets is $16,667,667 ($10,000,000 + $6,667,667)

Additional information concerning this method can be found in "Valuing a Business" by Pratt, Reilly and Schweihs.

<u>Caution:</u> Valuations are far from an exact science. Thus, great care must be exercised with any valuation method.

5.7 PRE-LIMITATION AMOUNT

5.7.1 Definition of Pre-Limitation Amount

An S corporation's "pre-limitation amount" is its taxable income determined by using all rules applying to C corporations and considering only its recognized built-in gain, recognized built-in loss, and recognized built-in gain carryover.

Example A

ABC, Inc., an accrual basis taxpayer, was incorporated on 12/1/87.

On 1/1/00, ABC made a federal and California S election.

After examination of the ABC's books and records for IYE 12/00, the auditor identifies items of built-in gain (loss). The auditor computes ABC's "pre-limitation amount" -- taxable income computed by using all rules applying to C corporation and considering only its recognized built-in gain, recognized built-in loss, and recognized built-in gain carryover (net operating and capital loss carryovers from C corporation years):

	Recognized Built-in Gain	Recognized Built-in Loss	Pre-Limitation Amount
1. Installment sale income	$2,500,000		
2. Bad debt recovery	150,000		
3. Sale of machinery	100,000		
4. Recognized built-in gain carryover	0		$2,750,000
5. Sale of building		-575,000	-575,000
6. Total			$2,175,000

Because this was ABC's first year as an S corporation, it had no "recognized built-in gain carryover".
ABC reported a net operating loss of ($350,000) in IYE 12/99.
ABC's pre-limitation amount is $2,175,000.

5.7.2 Computing Pre-Limitation Amount when Recognition Period Ends During the S Corporation's Taxable Year

If the recognition period for certain assets ends during an S corporation's taxable year (for example, because the corporation was on a fiscal year as a C corporation and changed to a calendar year as an S corporation or because an S corporation acquired assets in a IRC §1374(d)(8) transaction during a taxable year), the S corporation must determine its pre-limitation amount for the year as if the corporation's books were closed at the end of the recognition period.

Example A

ABC, Inc., a C corporation, reported on a fiscal year ending October 31.

ABC made a federal and California S election effective beginning 11/1/94. It filed a calendar year end return on 12/31/94.

ABC's recognition period is the 120-month period covering 11/1/94 - 10/31/04.

In IYE 12/04, ABC reported the following gains on asset dispositions for assets held on 11/1/94 (the date of conversion to an S corporation):

1. Land (sold on 9/3/04)	$1,000,000
2. Building (sold on 9/3/04)	5,000,000
3. Building (sold on 11/30/04)	10,000,000

In computing ABC's "pre-limitation amount", only asset sales occurring from 1/1/04 - 10/31/04 are included (last 10 months of recognition period). The building sold on 11/30/04 for a $10,000,000 gain would fall outside the recognition period and would not be included in the "pre-limitation amount".

5.8 TAXABLE INCOME LIMITATION

The taxable income limitation refers to an S corporation's taxable income determined by using all rules applying to C corporations (IRC §63(a)), as modified by IRC §1375(b)(1)(B).

IRC §1375(b)(1)(B) disregards the following deductions in computing the taxable income limitation:

- IRC §172 – Net operating loss deduction (R&TC §24416)
- IRC §241 – Allowance of special deductions (R&TC §24401)
- IRC §243 – Dividends received by corporations (R&TC §24402)
- IRC §244 – Dividends received on certain preferred stock (R&TC §24402)
- IRC §245 – Dividends received from certain foreign corporations (R&TC §24402)
- IRC §246 – Rules applying to deductions for dividends received (R&TC §24402)
- IRC §246A – Dividends received deduction reduced where portfolio stock is debt financed
- IRC §247 – Dividends paid on certain preferred stock of public utilities (R&TC §24402)
- IRC §249 – Limitation on deduction of bond premium on repurchase (R&TC §24439)

Final regulations require the S corporation to use the accounting methods it actually uses as an S corporation to make this taxable income determination.

Example A

As Reported per Return:

1.	Ordinary income (loss) from trade or business activities from federal 1120S, line 21.	$50,000
2.	Foreign or domestic tax based on income or profits and California franchise or income tax	15,000
3.	Interest on government obligations	1,000

4.	Net capital gain from Schedule D (100S), Section B		850,000
5.	Depreciation and amortization adjustments		-25,000
6.	Portfolio income		10,000
7.	Contributions		-1,000
8.	Net income (loss) after state adjustments		$900,000
9.	Net income (loss) for state purposes		$900,000
10.	R&TC §23802(e) deduction	850,000	
11.	Net operating loss carryover deduction	50,000	900,000
12.	Net income for tax purposes		$0

Total net operating loss carryover = $700,000.

The taxable income limitation for California purposes is net income (loss) after state adjustments, $900,000. The net operating loss carryover of $700,000 is not part of the taxable income limitation computation.

Note: In this example there were no IRC §241-249 deductions required to be added back to net income (loss) after state adjustments for purposes of computing the taxable income limitation.

5.9 NET UNREALIZED BUILT-IN GAIN

5.9.1 Definition of Net Unrealized Built-in Gain

Net unrealized built-in gain is the upper limit of net recognized built-in gain subject to the built-in gains tax during the recognition period. (IRC §1374(c)(2)(A))

It is the excess of the fair market value of the assets of the S corporation as of the beginning of its 1st taxable year in which an election is made over the aggregate adjusted bases of such assets at such time. (IRC §1374(d)(1)) It also includes items of income and deduction treated as recognized built-in gains or losses during the recognition period. (IRC §1374(d)(5)(C))

5.9.2 Computing Net Unrealized Built-in Gain

The maximum net unrealized built-in gain subject to the built-in gains tax during the recognition period is the total of the following, as determined on the date the S election was effective.

1. The amount that would be the amount realized if, at the beginning of the first day of the recognition period, the corporation had remained a C corporation and had sold all its assets at fair market value to an unrelated party that assumed all its liabilities; decreased by

2. Any liability of the corporation that would be included in the amount realized on the sale referred to in (1), but only if the corporation would be allowed a deduction on payment of the liability; decreased by

3. The aggregate adjusted bases of the corporation’s assets at the time of the sale referred to in (1); increased or decreased by

4. The corporation's IRC §481 adjustments that would be taken into account on the sale referred to in (1); and increased by

5. Any recognized built-in loss that would not be allowed as a deduction under IRC §382, IRC §383, or IRC §384 on the sale referred to in paragraph (1).

(See Treas. Reg. § 1.1374-3)

Example A

ABC, Inc. is a calendar year C corporation using the cash method. It elects to become an S corporation on January 1, 2004 and, on this day, has assets and liabilities as follows:

Assets	FMV on 1/1/04	Adjusted Basis	Built-in Gain (Loss)
Cash	$10,000	$10,000	$0
Accounts receivable	50,000	0	$50,000
Building	100,000	30,000	70,000
Machine #1	17,000	15,000	2,000
Machine #2	8,000	10,000	-2,000
Furniture & fixtures	1,000	2,000	-1,000
Leasehold improvements	70,000	35,000	35,000
Goodwill	150,000	0	150,000
Total Assets	396,000	92,000	304,000
Liabilities			
Mortgage	-100,000		
Rent payable *	-10,000	0	-10,000
Supplies payable *	-5,000	0	-5,000
Wages payable *	-15,000	0	-15,000
Total liabilities	-130,000		-30,000

*Deductible when paid.

ABC, Inc. also had IRC §481(a) income of $300,000 to be reported after conversion.

ABC, Inc.'s net unrealized built-in gain at the date of conversion is:

1.	Amount realized if assets sold at fair market value and liabilities assumed	$396,000
2.	Less: Liability if corporation allowed a deduction on payment	-30,000
3.	Less: Aggregate adjusted basis of assets	-92,000
4.	Plus: IRC §481(a) income	300,000
5.	Plus: Recognized built-in loss not deductible under IRC §382, IRC §383, and IRC §384	0
	Net Unrealized Built-In Gain	**$574,000**

5.9.3 Net Unrealized Built-in Gain Unknown

The IRS and Treasury believe that using a valuation approach for determining "net unrealized built-in gain" is not unduly burdensome because IRC §1374(d)(1) defines net unrecognized built-in gain using an aggregate method. They also believe that many S corporations will not need to know their "net unrealized built-in gain" because they will not approach their "net unrealized built-in gain" limitation during the recognition period.

Keep in mind, however, that the S corporation is responsible for asset valuations at the date of conversion. Without such computation, the corporation may be subject to built-in gains tax on "recognized built-in gains" in excess of its "net unrealized built-in gain".

5.10 NET RECOGNIZED BUILT-IN GAIN

5.10.1 In General

Net recognized built-in gain is the maximum amount subject to the built-in gains tax during the tax year. This amount is computed after determining the pre-limitation amount, taxable income limitation, and net unrealized built-in gain. Per Treas. Reg. §1.1374-2(a), an S corporation's net recognized built-in gain for any taxable year is the least of:

Pre-limitation amount -

Its taxable income determined by using all rules applying to C corporations and considering only its recognized built-in gain, recognized built-in loss, and recognized built-in gain carryover;

Taxable income limitation –

Its taxable income determined by using all rules applying to C corporations as modified by IRC §1375(b)(1)(B); and
Net unrealized built-in gain limitation –

The amount by which its net unrealized built-in gain exceeds its net recognized built-in gains for all prior taxable years.

5.10.2 Allocation Rule

If an S corporation's pre-limitation amount for any taxable year exceeds its net recognized built-in gain for that year, the S corporation's net recognized built-in gain consists of a ratable portion of each item of income, gain, loss, and deduction included in the pre-limitation amount. (Treas. Reg. §1.1374-2(b))

Example A

Computation of net recognized built-in gain - lesser of:

1.	Pre-limitation amount [sum of recognized (1) built-in gain, (2) built-in loss, and (3) built-in gain carryover:		
	Sale of building	$500,000	
	Sale of land	-200,000	
	Sale of goodwill	1,000,000	
	Total pre-limitation amount		$1,300,000
2.	Taxable income limitation		**$500,000**
3.	Net unrealized built-in gain		$5,000,000

The S corporation's net recognized built-in gain is $500,000.

Because the pre-limitation amount of $1,300,000 exceeds the net recognized built-in gain of $500,000, the net recognized built-in gain is prorated as follows:

Pre-limitation Item	Pre-limitation Amount	Ratio	Taxable Income Limitation	Pro rata Recognized	Pro rata Carried Over
Sale of building	$500,000	.38		$190,000	$310,000
Sale of land	-200,000	-.15		-75,000	-125,000
Sale of goodwill	1,000,000	.77		385,000	615,000
Total	$1,300,000	1.000	$500,000	$500,000	$800,000

5.10.3 Recognized Built-in Gain Carryover

IRC §1374(d)(2)(B) requires net built-in gains in excess of the taxable income limitation to be carried forward if the S election was made on or after March 31, 1988. The intent of this subparagraph was to prevent S corporations from moving items of built-in gain into net operating loss years.

Example A

Computation of net recognized built-in gain - lesser of:

1. Pre-limitation amount [sum of recognized (1) built-in gain, (2) built-in loss, (3) built-in gain carryover, and (4) IRC §1374 attributes]:

Sale of machinery	$500,000	
Installment sale income	100,000	
Sale of land	1,000,000	
Total pre-limitation amount		$1,600,000

2.	Taxable income limitation	$1,000,000
3.	Net unrealized built-in gain	$5,000,000

The S corporation's net recognized built-in gain is $1,000,000.

Because the pre-limitation amount of $1,600,000 exceeds the net recognized built-in gain of $1,000,000, the net recognized built-in gain is prorated as follows:

Pre-limitation Item	Pre-limitation Amount	Taxable Income Ratio	Pro rata Limitation	Pro rata Recognized	Pro rata Carryover Amount
Sale of machinery	$500,000	.31		$310,000	$190,000
Installment sale income	100,000	.06		60,000	40,000
Sale of land	1,000,000	.63		630,000	370,000
Total	$1,600,000	1.00	$1,000,000	$1,000,000	$600,000

Succeeding Taxable Year:
The pre-limitation amount would include the sum of (1) recognized built-in gain, (2) recognized built-in loss, and (3) built-in gain carryover as follows - (a) sale of machinery, $190,000; (b) installment sale income, $40,000; and (c) sale of land, $370,000.

EXAMPLE B

This example is contained in Treas. Reg. §1.1374-2(e)
ABC, Inc. converted from a C to an S corporation on 1/1/04.

On 1/1/04, ABC reported a net unrealized built-in gain of $50,000; a net operating loss carryover of $0; and a capital loss carryover of $0.

During 2004, its first S year, it generated $20,000 in realized built-in gains from an IRC §481(a) cash to accrual adjustment of $15,000, classified as ordinary income, and an asset sale resulting in a $5,000 capital gain.

On 12/31/04, ABC reported taxable income determined by using C corporation rules of $9,600.

ABC's net recognized built-in gain is the lesser of:

Pre-limitation amount (net unrealized built-in gain)	20,000
Taxable income limitation (computed as if a C corporation)	9,600
Net unrealized built-in gain limitation (at date of conversion)	50,000

Because ABC's pre-limitation amount of $20,000 exceeded its net recognized built-in gain of $9,600, ordinary income of $15,000 and capital gain of $5,000 must be allocated as follows:

Recognized built-in gain/ordinary income: (15,000 / 20,000) x 9,600 = $7,200
Recognized built-in gain/capital gain: (5,000 / 20,000) x 9,600 = $2,400

ABC has recognized built-in gain carryover to 2005 of:

Ordinary income: $15,000 - $7,200 = $7,800
Capital gain: $5,000 - $2,400 = $2,600

Treas. Reg. §1.1374-2(c) also provides that if an S corporation's net recognized built-in gain for any taxable year is equal to its taxable income limitation, the amount by which its pre-limitation amount exceeds its taxable income limitation is a recognized built-in gain carryover included in its pre-limitation amount for the succeeding taxable year. The recognized built-in gain carryover consists of that portion of each item of income, gain, loss, and deduction not included in the S corporation's net recognized built-in gain for the year the carryover arose.

5.11 IRC §1374(D)(8) ASSET ACQUISITIONS

5.11.1 S Corporations that Become Subject to the Built-in Gains Tax Pursuant to IRC §1374(d)(8) Asset Acquisitions

A corporation that has always been an S corporation is usually not subject to the built-in gains tax. It becomes subject to the tax only in regards to assets acquired in a transaction in which the S corporation's bases in the assets are determined (in whole or in part) by reference to a C corporation's bases in the assets. (IRC §1374(d)(8)) Be aware that the Anti-Stuffing Rule may be applicable to certain situations. (Treas. Reg. §1.1374-9)

5.11.2 Separate Determinations of Tax and Taxable Income Limitations

Final Reg. §1.1374-8(c))requires that the built-in gains tax be separately determined with respect to:

- Assets that the S corporation acquired in an IRC §1374(d)(8) transaction,
- Assets that the S corporation acquired in another IRC §1374(d)(8) transaction,
- Assets that were held when the corporation became an S corporation.

The above requirements necessitate identification and separate treatment of items of built-in gain (loss) and application of net operating loss and capital loss carryovers from C corporation years. In other words, an S corporation's net operating and capital loss carryovers when it becomes an S corporation may only be used to reduce the built-in gains generated on dispositions of assets that the S corporation held at that time. Similarly, an S corporation's net operating and capital loss carryovers acquired in an IRC §1374(d)(8) transaction may only be used to reduce the built-in gains generated on dispositions of assets that S corporation acquired in the same transaction.

If the aggregate "net recognized built-in gain" from all sources exceeds the net income limitation for the year, each "net recognized built-in gain" determination is allocated based on the ratio of each of those determinations to the sum of all of those determinations.

Example A

ABC, Inc. was incorporated on 1/1/90 and immediately made a federal S election, and a deemed California S election. Therefore, ABC, Inc. was not subject to the built-in gains tax rules for federal or California purposes.

On 1/1/03, XYZ (an unrelated C corporation) merges into ABC pursuant to an IRC §368(a)(1)(A) transaction.

XYZ's assets acquired by ABC are subject to the built-in gains rules and have a "net unrealized built-in gain" of $150,000. XYZ had no net operating or capital loss carryovers at the time of merger.

During 2003, ABC sold assets acquired from XYZ resulting in a recognized built-in gain of $50,000. ABC's "net recognized built-in gain" was computed as the least of:

1.	Pre-limitation amount (recognized built-in gain)	$50,000
2.	Taxable income	100,000
3.	Net unrealized built-in gain	150,000

ABC's "net recognized built-in gain" is $50,000.

Example B

ABC, Inc., a C corporation, makes a valid federal and California S election effective on 1/1/03 and is, therefore, subject to the built-in gains tax rules for federal or California purposes.

ABC reported the following on 1/1/03:

1. Net unrealized built-in gain	$5,000
2. Net operating loss carryover	0

On 1/1/04, XYZ (an unrelated C corporation) merges into ABC pursuant to an IRC §368(a)(1)(A) transaction.

XYZ reported the following on 1/1/04:

1. Net unrealized built-in gain	$80,000
2. Net operating loss carryover	0

During 2004, ABC sold built-in gain assets totaling $30,000 (pre-limitation amount): Of this amount, $15,000 was from assets held by ABC prior to conversion and $15,000 was from assets acquired from XYZ.
ABC reported taxable income of $10,000 for IYE 12/04.
“Net recognized built-in gain” for IYE 12/04 is computed in stages as follows.

	ABC’s Assets	XYZ’s Assets	Total
Lesser of the Parts:			
1. Pre-limitation amount	$15,000	$15,000	
2. Net unrealized built-in gain	5,000	80,000	
Lesser of the Totals:			
3. Lesser of (1) or (2) above	5,000	15,000	20,000
4. Taxable income			10,000

In this example, built-in gain tax would be assessed on $10,000. Because the taxable income limitation applied and there were separate determinations, “net recognized built-in gain” must be allocated as follows:

ABC’s Assets	$2,500	[$10,000 x (5,000 / 20,000)]
XYZ’s Assets	$7,500	[$10,000 x (15,000 / 20,000)]

The $10,000 of taxable gain excluded from tax as a result of the corporation's taxable income limitation will be treated as a carryover in the computation of the corporation's pre-limitation amount for the succeeding year.

5.12 SPECIAL RULES FOR INSTALLMENT SALES

5.12.1 Installment Sales Entered into Prior to March 26, 1990

Income received during the recognition period for installment sales entered into prior to March 26, 1990 follow the normal built-in gains rules.

Example A

ABC, Inc., a C corporation, entered into an installment sale for $5,000,000 on 10/1/88. It received $250,000 each year for the next 20 years on October 1 beginning in 1989.

ABC made a federal and California S election effective on 1/1/00.

On 1/1/00, ABC had uncollected installment sales proceeds of $2,250,000 [$5,000,000 –2,275,000 (250,000 X 11 prior payments)].

ABC would include the $250,000 recognized built-in gain from the installment sale in its "pre-limitation amount" each year during the period covering IYE 12/00 - 12/08.

ABC's net recognized built-in gain for each year would be the least of its (a) pre-limitation amount, (b) taxable income limitation, or (c) net unrealized built-in gain.

The corporation would be required to carryover amounts in excess of the taxable income limitation until the end of its recognition period, 12/31/09. Unused carryover amounts are lost as of 12/31/09.

5.12.2 Installment Sales Entered Into On or After March 26, 1990 and Before December 27, 1994

Installment sales entered into on or after March 26, 1990 and before December 27, 1994 follow the rules provided in Treas. Reg. §1.1374-10(b)(4). If a binding contract was in effect before March 26, 1990, however, the sale follows the rules for installment sales entered into before March 26, 1990.

Treas. Reg. §1.1374-10(b)(4) states that if a taxpayer sells an asset either prior to or during the recognition period and recognizes income either during or after the recognition period from the sale under the installment method, the income will, when recognized, be taxed under IRC §1374 to the extent it would have been so taxed in prior taxable years if the selling corporation had made the election under IRC §453(d) not to report the income under the installment method. For purposes of determining the extent to which the income would have been subject to tax if the IRC §453(d) election had not been made, the taxable income limitation of IRC §1374(d)(2)(A)(ii) and the built-in gain carryover rule of IRC §1374(d)(2)(B) will be taken into account.

Example A

On April 1, 1990, Z Corp. closes an installment sale and realizes a $250,000 gain, which it reports on the installment method. On January 1, 1995 $100,000 of the gain is unreported. Z Corp. becomes an S Corporation on that date and determines that its net unrealized built-in gain (including the $100,000 deferred installment gain) is $325,000. Z Corp has no income or loss for its first year in S status and breaks even for all other years within the recognition period. No other built-in gains or losses are recognized. The 10-year recognition period expires on December 31, 2004, and the corporation receives full payment on the note in 2005.

When an asset is sold on the installment basis, the entire amount of income not recognized before the recognition period is treated as having been reported in the first year of the recognition period for purposes of computing the built-in gains tax. Under this provision, Z Corp. treats the $100,000 of unreported gain as if the installment sale occurred in 1995. If the sale had taken place in that year, and if Z corp. had elected out of the installment method, the corporation's net income for the year would have been $100,000. Thus, the $100,000 installment gain is subject to the built in gains tax when the note is collected in 2005, even thought the recovery period has expired.

Example B

In year 1 of the recognition period under IRC §1374, a corporation realizes a gain of $100,000 on the sale of an asset with built-in gain. The corporation is to receive full payment for the asset in year 11. Because the corporation does not make an election under IRC §453(d), all $100,000 of the gain from the sale is reported under the installment method in year 11. If the corporation had made an election under IRC §453(d) with respect to the sale, the gain would have been recognized in year 1 and, taking into account the corporation’s income and gains from other sources, application of the taxable income limitation of IRC §1374(d)(2)(A)(ii) and the built-in gain carryover rule of IRC §1374(d)(2)(B) would have resulted in $40,000 of the gain being subject to tax during the recognition period under IRC §1374. Therefore, $40,000 of the gain recognized in year 11 is subject to tax under IRC §1374.

Example C

In year 1 of the recognition period under IRC §1374, a corporation realizes a gain of $100,000 on the sale of an asset with built-in gain. The corporation is to receive full payment for the asset in year 6. Because the corporation does not make an election under IRC §453(d), all $100,000 of the gain from the sale is reported under the installment method in year 6. If the corporation had made an election under IRC §453(d) with respect to the sale, the gain would have been recognized in year 1 and, taking into account the corporation’s income and gains from other sources, application of the taxable income limitation of IRC §1374(d)(2)(A)(ii) and the built-in gain carryover rule of IRC §1374(d)(2)(B) would have resulted in all of the gain being subjected to tax under IRC §1374 in years 1 through 5. Therefore, notwithstanding that the taxable income limitation of IRC §1374(d)(2)(A)(ii) might otherwise limit the taxation of the gain recognized in year 6, the entire $100,000 of gain will be subject to tax under IRC §1374 when it is recognized in year 6.

5.12.3 Installment Sales Entered Into On or After December 27, 1994

a. General Rule

Per Treas. Reg. §1.1374-4(h)(1), if a corporation sells an asset either prior to or during the recognition period and reports income (either during or after the recognition period) from the sale using the installment method, that income is an item of built-in gain to the extent it would have been tax in prior years if the corporation had elected out of the installment method.

b. Limitation on Amount Subject to Tax

The taxable income limitation is the amount by which the S corporation's net recognized built-in gain would have increased from the year of the sale to the earlier of the year the income is reported under the installment method or the last year of the recognition period, assuming all income from the sale had been reported in the year of the sale and all provisions of IRC §1374 applied. If the corporation sells the asset before the recognition period, the income from the sale that is not reported before the recognition period is treated as having been reported in the first year of the recognition period.

c. Rollover Rule

The excess of the built-in gain reported under the installment method over the amount subject to tax under the taxable income limitation is treated as if it were reported in the succeeding taxable year(s), but only for succeeding taxable year(s) in the recognition period. The amount reported in the succeeding taxable year(s) under the preceding sentence is reduced to the extent that the amount not subject to tax under the limitation was not subject to tax because the S corporation had an excess of recognized built-in loss over recognized built-in gain in the taxable year of the sale and succeeding taxable year(s) in the recognition period.

Example A – Roll Over Rule:

ABC, Inc. makes an S election effective 1/1/00.

On 1/1/00, ABC sells real property with a basis of $0 and a fair market value of $100,000 in exchange for a $100,000 note. ABC reports the sale using the installment sale method under IRC §453.

In year 2005, ABC receives full payment on the note and reports the gain on Sch. D.

ABC net income after state adjustments for 2005 is $0.

If ABC had reported the $100,000 gain in 2000, its net recognized built-in gain from 2000 to 2005 would have been $75,000 greater than otherwise.

Per Treas. Reg. §1.1374-4(h), ABC has $75,000 net recognized built-in gain subject to the built-in gains tax. ABC also must treat the $25,000 excess of the amount reported, $100,000, over the amount subject to tax, $75,000, as income reported under the installment method in the succeeding taxable year(s) in the recognition period, except to the extent ABC establishes that the $25,000 was not subject to tax under IRC §1374 in the year 2005 because ABC had an excess of recognized built-in loss over recognized built-in gain in the taxable year of the sale and succeeding taxable year(s) in the recognition period.

d. Use of Losses and IRC §1374 Attributes

If an S corporation reports income under the installment method for a taxable year after the recognition period and the income is subject to IRC §1374 tax, then the S corporation’s IRC §1374 attributes may be used to the extent their use is allowed under all applicable provisions of the IRC in determining the IRC §1374 tax. However, the S corporation’s loss recognized for a taxable year after the recognition period that would have been recognized built-in loss if it had been recognized in the recognition period may not be used in determining the IRC §1374 tax.

5.12.4 Liquidating Distribution of Installment Note

For federal purpose when an S Corporation distributes an Installment Note it will not recognize gain under IRC §453B(h). However, IRC §453B(h)(2) excludes the preferential treatment for BIG's tax by stating, "except for purposes of any tax imposed by subchapter S." Therefore, for federal purpose the S Corporation must recognize the BIG's portion of the under IRC §336 and pay BIG's tax under IRC §1374.

However, for state purpose when the Installment Note is distributed and the gain from installment transactions has not been fully reported, the unreported income must be included in the measure of tax for the last year the taxpayer is subject to a tax measured by net income. (R&TC §24672) (Appeal of Kavanaugh – April 20, 2007 – Cal. St. Bd. of Equal. Case No. 348937, not to be cited as precedent.)

Additionally, any built-in gains tax associated with the transaction will be imposed pursuant to IRC §1374.

See section 15.3.2 for additional details.

5.13 SPECIAL RULES FOR PARTNERSHIP INTERESTS

In general, an S corporation owning an interest in a partnership must treat its distributive share of the partnership's items as recognized built-in gain or loss to the extent the S corporation's distributive share would have been treated as recognized built-in gains or loss if the items originated in, and were taken into account directly by, the S corporation (the "look-through rule").

The "look-through rule" applies to the extent the S corporation had built-in gain or built-in loss in its partnership interest at the beginning of the recognition period.

5.13.1 Taxable Years Ending Before December 27, 1994

Treas. Reg. §1.1374-10(b)(1) provides that if a corporation transfers an asset to a partnership in a transaction to which IRC §721(a) applies and the transfer is made in contemplation of an S election or during the recognition period, IRC §1374 applies on a disposition of the asset by the partnership as if the S corporation had disposed of the asset itself.

The effective date of the above paragraph is for income years beginning on or after 1987 (the effective date of IRC §1374), unless the recognition period with respect to the contributed asset is pursuant to an S election or an IRC §1374(d)(8) transaction occurring on or after December 27, 1994.

5.13.2 Taxable Years Ending On or After December 27, 1994

a. In General

Per Treas. Reg. §1.1374-4(i)(1), if an S corporation owns a partnership interest at the beginning of the recognition period or transfers property to a partnership in a transaction to which IRC §1374(d)(6) applies during the recognition period, the S corporation determines the effect on net recognized built-in gain from its distributive share of partnership items as follows:

Step 1: Apply the rules of IRC §1374(d) to the S corporation's distribute share of partnership items of income, gain, loss, or deduction included in income or allowed as a deduction under the rules of subchapter K to determine the extent to which it would have been treated as recognized built-in gain or loss if the partnership items had originated in and been taken into account directly by the S corporation (partnership 1374 items);

Step 2: Determine the S corporation's net recognized built-in gain without partnership IRC §1374 items;

Step 3: Determine the S corporation's net recognized built-in gain with partnership IRC §1374 items; and

Step 4: If the amount computed under Step 3 exceeds the amount computed under Step 2, the excess is the S corporation's partnership RBIG, and the S corporation's net recognized built-in gain is the sum of the amount computed under Step 2 plus the partnership RBIG. (Treas. Reg. §1.1374-4(i)(1)(iv)) If the amount computed under Step 2 exceeds the amount computed under Step 3, the excess is the S corporation's partnership RBIL, and the S corporation's net recognized built-in gain is the remainder of the amount computed under Step 2 after subtracting the partnership RBIL.

b. Limitations

An S corporation's partnership RBIG for any taxable year may not exceed the excess (if any) of the S corporation's RBIG limitation over its partnership

RBIG for prior taxable year. However, this limitation does not apply if the S corporation formed the partnership or transferred property to the partnership for the principal purpose of avoiding the tax imposed under IRC §1374.

An S corporation's partnership RBIL for any taxable year may not exceed the excess (if any) of the S corporation's RBIL limitation over its partnership RBIL for prior taxable years.

c. Disposition of Partnership Interest

If an S corporation disposes of its partnership interest, the amount that is treated as recognized built-in gain may not exceed the excess (if any) of the S corporation's RBIG limitation over its partnership RBIG during the recognition period. Similarly, the amount that is treated as recognized built-in loss may not exceed the excess (if any) of the S corporation's RBIL limitation over its partnership RBIL during the recognition period.

d. RBIG and RBIL Limitations

An S corporation's RBIG or RBIL limitation upon the sale of its partnership interest is the total of the following:

The amount that would be the amount realized if, at the beginning of the first day of the recognition period, the corporation had remained a C corporation and had sold its partnership interest (and any assets the corporation contributed to the partnership during the recognition period) at fair market value to an unrelated party; decreased by
The corporation's adjusted basis in the partnership interest (and any assets the corporation contributed to the partnership during the recognition period) at the time of sale; and increase or decreased by

- The corporation's allocable share of the partnership's IRC §481(a) adjustments at the time sale.

- If the above results in a positive amount, the S corporation has a RBIG limitation equal to that amount and a RBIL limitation of $0.

- If the above results in a negative amount, the S corporation has a RBIL limitation equal to that amount and a RGIB limitation of $0.

e. Small Interest Exception

The “small interest” exception explains that the partnership interest rules under Treas. Reg. §1.1374-4(i)(1) do not apply to an S corporation if it can satisfy the small interest exception with respect to its partnership interest. The “small interest” exception to the “look-through rules” generally applies for a taxable year if (1) the S corporation’s interest in the partnership represents less than 10% of the partnership’s profits and capital at all times during the taxable year and prior taxable years in the recognition period, and (2) has a value less than $100,000 as of the beginning of the recognition period.

However, if the S corporation contributes an asset to the partnership in the recognition period and the S corporation held the asset as of the beginning of the recognition period, the fair market value of the S corporation’s partnership interest as of the beginning of the recognition period is determined as if the asset was contributed to the partnership before the beginning of the recognition period (using the fair market value of the asset as of beginning of the recognition period.

f. Examples (Based on Examples Provided in the Regulations)

Example A

ABC, Inc. makes a valid federal and California S election on 1/1/02.

ABC owns 50% of partnership, PS, on the election date. On 1/1/02, PS owns a parcel of land (Parcel #1) with a basis of $25,000; FMV, $45,000.

During 2002, PS buys another parcel of land (Parcel #2) for $50,000.

In 2003, PS sells (1) Parcel #1 for $55,000 and recognizes a $30,000 gain, and (2) Parcel #2 for $42,000 and recognizes a loss of -$8,000.

If ABC could not provide documentation to support appreciation of Parcel #1 during C vs. S corporation years, ABC's distributive share on the sale of Parcel #1 of $15,000 ($30,000 x 50%) would be recognized built-in gain.

Parcel #2 was purchased after the date of conversion and is not an item of built-in gain (loss).

Example B

ABC, Inc. makes a valid federal and California S election on 1/1/00. It owned land with a basis of $100,000; FMV of $200,000 on this date.

On 1/1/02, ABC contributes the land to partnership, PS, in exchange for 50% partnership interest.

On 1/1/04, PS sells the land for $300,000 and recognizes a $200,000 gain.

ABC is allocated $100,000 of the gain under IRC §704(c) and $50,000 - its percent share of the remainder.

Because ABC knew the value of the property to be $200,000 at the date of conversion, therefore, $100,000 ($200,000 FMV - $100,000 basis at conversion) would be subject to the built-in gains tax as a partnership IRC §1374 item.

Example C

ABC, Inc. makes a valid federal and California S election on 1/1/02.

ABC owns 50% of partnership, PS, on the election date. PS owns land with a basis of $50,000; FMV, $200,000. ABC's RBIG limitation in regards to PS is $100,000; RBIL limitation, $0.

In 2002, PS sells the land for $200,000 and recognizes a $150,000 gain, of which $75,000 is ABC's share and is treated as a partnership built-in gain item by ABC.

ABC's "net recognized built-in gain" without partnership items is $35,000 in 2002; $110,000 with partnership items ($35,000 + $75,000).

ABC has a partnership RBIG of $75,000 for the year. Because ABC's RBIG limitation is $100,000, ABC is not limited by ABC's partnership RBIG of $75,000. ABC's net recognized built-in gain is $110,000.

If ABC's RBIG limitation in regards to PS were $50,000, ABC would have net recognized built-in gain of $85,000 ($35,000 + $50,000).

Example D

ABC, Inc. makes a valid federal and California S election on 1/1/02.

ABC owns 50% of partnership, PS, on the election date. PS owns land with a basis of $225,000; FMV, $125,000. ABC's RBIG limitation in regards to PS is $0; RBIL limitation, $60,000.

In 2002, PS sells the land for $125,000 and recognizes a -$100,000 loss, of which -$50,000 is ABC's share and is treated as a partnership built-in loss item by ABC.

ABC's "net recognized built-in gain" without partnership items is $75,000 in 2002; $25,000 with partnership items ($75,000 - $50,000).

ABC has a partnership RBIL of $50,000 for the year. Because ABC's RBIL limitation is $60,000, ABC is not limited by ABC's partnership RBIL of $60,000. ABC's net recognized built-in gain is $25,000.

If ABC's RBIL limitation in regards to PS was $40,000, ABC would have net recognized built-in gain of $35,000 ($75,000 - $40,000).

Example E

ABC, Inc. makes a valid federal and California S election on 1/1/02.

ABC owns 50% of partnership, PS, on the election date. ABC's RBIG limitation in regards to PS is $0; RBIL limitation, $25,000.

In 2002, ABC and PS report the following built-in gain (loss) items:

ABC	
Recognized built-in ordinary income	$40,000
Recognized built-in capital loss	-90,000
PS	
Ordinary income	$25,000
Capital gain	75,000

ABC's "net recognized built-in gain" without partnership items is $40,000 in 2002; $65,000 with partnership items ($40,000 + $25,000).

ABC has a partnership RBIG of $25,000 for the year. Because ABC's RBIG limitation is $0, ABC's partnership RBIG of $25,000 is limited to $0. ABC's net recognized built-in gain for the year is $40,000.

Example F

ABC, Inc. makes a valid federal and California S election on 1/1/02.

ABC owns 50% of partnership, PS, on the election date. ABC's RBIG limitation in regards to PS is $60,000; RBIL limitation, $0.

In 2002, ABC and PS report the following built-in gain (loss) items:

ABC	
Recognized built-in ordinary income	$40,000
Recognized built-in capital gain	75,000
PS	
Ordinary income	$25,000
Capital loss	-90,000

ABC's "net recognized built-in gain" without partnership items is $115,000 in 2002 ($40,000 + $75,000); $65,000 with partnership items ($40,000 +

$25,000).

ABC has a partnership RBIL of $50,000 for the year. Because ABC's RBIL limitation is $0, ABC's partnership RBIL of $50,000 is limited to $0. ABC's net recognized built-in gain for the year is $115,000.

Example G

ABC, Inc. makes a valid federal and California S election on 1/1/02.

ABC owns 50% of partnership, PS, on the election date. ABC's RBIG limitation in regards to PS is $200,000; RBIL limitation, $0. PS owns land with a basis of $20,000; FMV, $140,000.

In 2002, PS sells the land for $140,000 and recognizes a $120,000 gain, of which $60,000 is ABC's share and is treated as a partnership built-in gain item by ABC.

ABC's "net recognized built-in gain" without partnership items is $95,000 in 2002; $155,000 with partnership items.

ABC has a partnership RBIG of $60,000 for the year.

In 2005, ABC sells its entire interest in PS for $350,000 and recognizes a $250,000 gain.

ABC's recognized built-in gain on the sale is limited by its RBIG limitation to $140,000 ($200,000 - $60,000).

Example H

ABC, Inc. makes a valid federal and California S election on 1/1/02.

On that date, ABC contributes Asset #1, 5-year property, with a basis of $0; FMV of $40,000. An unrelated party contributes $40,000 cash. Each own 50% partnership interest in partnership, PS.

PS adopts the traditional method under IRC §1.704-3(b). If PS sold Asset #1 immediately after contribution for $40,000, PS's $40,000 gain would be allocated to ABC under IRC §704(c).

Instead, PS sells Asset #1 in 2005 for $36,000 and recognizes a $36,000 gain ($36,000 - $0). Under IRC §704(c), ABC is allocated only $16,000 because of book depreciation of $8,000 per year ($36,000 - ($8,000 x 3 years)).

The remainder gain of $20,000 ($36,000 - $16,000) is allocated 50% between the partners per IRC §704(b).

ABC is allocated a gain of $26,000 ($16,000 + $10,000). ABC, however, treats the entire $36,000 gain as a partnership built-in gain items on PS's sale of Asset #1.

Example I

ABC, Inc. makes a valid federal and California S election on 1/1/02.

ABC owns 50% of partnership, PS, on the election date. On 1/1/02, PS owns land with a basis of $20,000; FMV, $40,000.

On 1/1/04, PS distributes the land to ABC, when the land had the same basis, but a FMV of $50,000.

Per IRC §732(a)(1), ABC has transferred basis of $20,000. On 1/1/05, ABC sells the land for $60,000 and recognizes a $40,000 gain.

Under IRC §1374(d)(3), ABC has recognized built-in gain from the sale of $20,000, the amount of built-in gain in the land on the first day of the recognition period.

5.14 BUILT-IN GAINS TAX IS A LOSS SUSTAINED BY THE CORPORATION

IRC §1366(f)(2) allows the shareholder of an S corporation a pass-through loss in the amount of the built-in gains tax paid by the S corporation. The S corporation is not allowed a loss deduction in the amount of the built-in gains tax paid for purposes of computing California Franchise or income tax.

R&TC §23803(b)(1) modifies this federal code section so that, for California purposes, the amount of loss sustained by the S corporation is the amount of built-in gains tax computed under California law. The amount of built-in gains tax flows through to shareholders as a loss sustained by the corporation during such taxable year, and the character of such loss is determined by allocating the loss proportionately among the recognized built-in gains giving rise to such tax.

EXAMPLE A

		Amount of Built-In Gain	Ratio	Built-In Gains Tax @ S Corporation Level	Pro Rata Built-in Gains Tax
1.	Ordinary Gain	$100,000	.10		$9,300
2.	Capital Gain	200,000	.20		18,600
3.	IRC §481 Income	700,000	.70		65,100
	Total	$1,000,000	1.00	$93,000	$93,000

The shareholder would include the following in the computation of shareholder basis:

		Item of Income	Item of Loss/Deduction
1.	Ordinary Gain	$100,000	-$9,300
2.	Capital Gain	200,000	-18,600
3.	IRC §481 Income	700,000	-65,100

If the shareholder has sufficient basis and is not restricted by other applicable limitations, the shareholder would report the following amounts per return:

Ordinary Gain, $90,700 [$100,000 - 9,300], to Form 4797.
Capital Gain, $181,400 [$200,000 - 18,600], to Schedule D.
IRC §481 Income, $634,900 [$700,000 - 65,100], to Schedule E.

Note: The built-in gains tax computed for California purposes is used in lieu of the federal amount.

Example B

Assume the same facts as in Example A except that the shareholder had insufficient basis to recognize all losses/deductions.

The shareholder would report the following amounts per return:
Ordinary Gain, $100,000, to Form 4797.
Capital Gain, $200,000, to Schedule D.
IRC §481 Income, $700,000, to Schedule E.

The shareholder would currently suspend the following losses/deductions (built-in gains tax):
Ordinary Loss, $9,300.
Capital Loss, $18,600.
IRC §481 Loss, $65,100.

Based on the above, it may be necessary to issue Notices of Proposed Overpayment (NPO) to the corporation's shareholders anytime the built-in gains (BIG) tax is increased due to an audit of the corporation. However, NPOs would not be needed whenever the BIG tax is assessed in the same year that the corporation liquidates because the reduced flow-through income would be exactly offset by the reduction in the shareholder's stock or debt basis.

Finally, per R&TC §23803(b)(1), the federal BIG tax is not a loss to the corporation for California purposes. If a corporation acquires an asset before or during the recognition period with a principal purpose of avoiding the tax imposed under IRC §1374, the asset and any loss, deduction, loss carryforward, credit, or credit carryforward attributable to the asset is disregarded in determining the S corporation's pre-limitation amount, taxable income limitation, net unrealized built-in gain limitation, deductions against net recognized built-in gain, and credits against the IRC §1374 tax. Thus, when a corporation has the same recognized built-in gain amount for both federal and state purposes, an addition should be present on the California Schedule K for the difference between the California and federal BIG tax amounts.

Example C

Assume a corporation's recognized BIG and capital gain amount for both federal and state purposes is $1 million. The corporation's net capital gain for federal purposes would be $650,000 based on a 35% federal BIG tax rate ($1,000,000 - $350,000) whereas the net capital gain for California purposes would be $911,600 ($1,000,000 - $88,400) based on a BIG tax rate of 8.84%. Thus, the California Schedule K should have an addition of $261,600 – the difference between the federal and California BIG tax.

5.15 COMPUTATION OF TAX

To prevent income from being subjected to both the S-corporation tax and the BIG tax, corporations are allowed a deduction, per R&TC §23802(e), for income subjected to the BIG tax. For tax year 2005, the deduction is located on line 17 of form 100S. The following example illustrates the mechanics of the form.

Example A

Assume that a corporation reports a capital gain of $1 million and that the entire amount is subject to the BIG tax. Based on the form 100S for 2001, the full $1 million capital gain should be reported on line 4 of the form and then deducted on line 17. As a result, the amount subject to the BIG tax is not included in the "Net income for tax purposes" on line 21, and the BIG tax amount is reported on line 28.